

Message Text

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TO SECSTATE WASHDC 4984
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PASS: CEA, TREAS, FRB

E.O. 11652: N/A
TAGS: OECD, ECON
SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF JAPAN

REF: (A) EDR(77)19; (B) PARIS 18200; (C) STATE 148164;
(D) TOKYO 9502; (E) TOKYO 9180

1. SUMMARY: AT JUNE 27 EDRC MEETING, JAPANESE DEL (16 STRONG AND LED BY MIYAZAKI, EPA) INSISTED, IN FACE OF CONSIDERABLE SKEPTICISM ON PART OF SECRETARIAT AND EDRC DELS, THAT CURRENT POLICY STANCE WOULD LEAD TO (A) ACHIEVEMENT OF FY77 GNP GROWTH TARGET (6.7 PERCENT); (B) STRONG SHIFT OF PATTERN OF GNP GROWTH TOWARD DOMESTIC DEMAND; AND (C) RETURN TO CURRENT ACCOUNT EQUILIBRIUM BY MARCH, 1978. MOREOVER, MIYAZAKI STRESSED THAT GOJ WOULD WATCH ECONOMIC SITUATION CLOSELY AND WOULD TAKE "TIMELY AND APPROPRIATE" ACTION IF IT BECAME LIMITED OFFICIAL USE

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LIKELY THAT GNP GROWTH TARGET WOULD NOT BE ACHIEVED. MAIN DIFFERENCE BETWEEN SECRETARIAT'S FORECAST OF GNP GROWTH IN CY1978 (5.5 PERCENT) AND JAPANESE PROJECTION FOR THIS PERIOD (6.2 PERCENT) IMPLIED BY GROWTH TARGET FOR FY77 CONCERNED GOJ'S RELATIVE OPTIMISM CONCERNING GROWTH OF PRIVATE INVESTMENT. FURTHERMORE, IN CONTRAST TO SECRETARIAT VIEW THAT IMPACT OF ALREADY-PROGRAMMED

FISCAL STIMULUS WOULD BE TEMPORARY, JAPANESE FELT THAT PROGRAM WOULD ENTRAIN ADDITIONAL PRIVATE SPENDING THEREBY AVERTING DECELERATION OF GNP GROWTH IN FIRST HALF OF 1978 AS FORECASTED BY SECRETARIAT. JAPANESE EXPECT SHARP DECLINE IN CURRENT ACCOUNT SURPLUS DURING FY1977 AND INDICATED THAT THIS MOVEMENT WOULD BE ASSISTED BY APPRECIATION OF YEN (WHOSE VALUE SHOULD BE DETERMINED BY MARKET FORCES) AND BY MAINTENANCE OF GENERALLY LIBERAL IMPORT REGIME. HOWEVER, THEY RESISTED EDRC DELS' ATTEMPTS TO EXTRACT CURRENT ACCOUNT FORECAST FOR CY1977. MIYAZAKI ALSO SAID THAT JAPAN WOULD ASSIST ADJUSTMENT PROCESS THROUGH ITS CONTRIBUTIONS TO IMF SPECIAL CREDIT FACILITY AND BY ITS INCREASED PARTICIPATION IN GENERAL AGREEMENT TO BORROW (GAB). UNCONVINCED, EDRC CONCLUDED THAT ON PRESENT POLICIES, JAPANESE LIKELY TO FALL SHORT OF ITS STATED GNP GROWTH TARGET AND THAT PATTERN OF GNP GROWTH WOULD BE SUB-OPTIMAL COMPARED WITH REQUIREMENTS OF BALANCE OF PAYMENTS ADJUSTMENT PROCESS. END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK FOR 1977:

MIYAZAKI INSISTED THAT ON BASIS OF PRESENT POLICIES, GOJ WOULD ACHIEVE 6.7 PERCENT GNP GROWTH RATE TARGETED FOR FY77. ATTAINMENT OF THIS TARGET IN FY77 WOULD IMPLY YEAR-OVER-YEAR GNP GROWTH RATE OF 6.2 PERCENT IN CY77, COMPARED WITH SECRETARIAT FORECAST OF 5.5 PERCENT FOR LIMITED OFFICIAL USE

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LATTER PERIOD. ENTIRE DIFFERENCE BETWEEN SECRETARIAT AND JAPANESE GROWTH FORECASTS FOR CY77 CONCERNED EXPECTED DEVELOPMENT OF PRIVATE INVESTMENT. JAPANESE CONSIDERED SECRETARIAT FORECAST OF 3.5 PERCENT RISE IN PRIVATE INVESTMENT TO BE OVERLY PESSIMISTIC AND NOTED THAT (A) CAPACITY UTILIZATION RATE, PRESENTLY AT 87.7 PERCENT SHOULD RISE TO 94-95 PERCENT BY END OF FY77 AND THUS BRING FORTH HIGHER INVESTMENT SPENDING; (B) INVESTMENT IN NON-MANUFACTURING SECTOR (ESPECIALLY ELECTRIC POWER) SHOULD BE STRONG, AND (C) SIGNIFICANT PICK-UP EXPECTED IN INVESTMENT BY SMALL AND MEDIUM-SIZED FIRMS. SECRETARIAT COUNTERED THAT RECENT SURVEYS OF BUSINESS EXPECTATIONS CONTINUED TO SHOW LACK OF CONFIDENCE AND INDICATED THAT INVESTMENT SPENDING COULD WELL DECLINE IN VOLUME TERMS THIS YEAR. JAPANESE ACKNOWLEDGED THAT CONFIDENCE WAS STILL WEAK, ADDED THAT LOW PROFITS (30-40 PERCENT BELOW PRE-OIL CRISIS LEVELS) WOULD INHIBIT INVESTMENT AND DID NOT DISAGREE WITH SECRETARIAT VIEW THAT SHIFT TO SLOWER GROWTH OVER MEDIUM TERM IMPLIED

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THAT RAPID ACCELERATION OF INVESTMENT SPENDING WAS NOT
LIKELY AND POSSIBLY NOT NECESSARY.

3. PRICES: JAPANESE INDICATED THAT APPRECIATION OF
YEN, TOGETHER WITH RELAXED SUPPLY/DEMAND CONDITIONS,
CONTRIBUTED TO RECENT MODERATION OF WHOLESALE PRICES.
ALTHOUGH CONSUMER PRICES CURRENTLY RISING AT ANNUAL RATE
OF 9 PERCENT, UNDERLYING RATE IS CLOSER TO 7 PERCENT.
JAPANESE EMPHASIZED THAT IMPORTANT POLICY OBJECTIVE
WOULD BE TO REDUCE INFLATION RATE FURTHER AND AVOIDANCE
OF ACCELERATION IN INFLATION WOULD THEREFORE CONSTITUTE
CONSTRAINT ON SPEED OF EXPANSION. SECRETARIAT, AND SOME
COUNTRY DELS, NOTED THAT FASTER GROWTH COULD WELL MOD-
ERATE UPWARD PRESSURE ON PRICES BY INDUCING RISE IN PRO-
DUCTIVITY. JAPANESE DID NOT ADDRESS THIS POINT
DIRECTLY, BUT FELT THAT INCREASED DEMAND MIGHT LEAD TO
HIGHER INFLATION AS FIRMS TOOK OPPORTUNITY TO WIDEN
PROFIT MARGINS. AUSTRALIANS, AS USUAL, POINTED OUT THAT
MORE RAPID GROWTH WOULD COMPROMISE GOJ'S ABILITY TO
EFFECT NEEDED REDUCTION IN REAL WAGES.

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4. OUTLOOK FOR FIRST HALF OF 1978: JAPANESE DEL TOOK ISSUE WITH SECRETARIAT VIEW THAT IMPACT OF PLANNED FISCAL STIMULUS WOULD BE TEMPORARY AND THAT GNP GROWTH WOULD DECELERATE TO 5 PERCENT ANNUAL RATE IN FIRST HALF OF 1978, FOLLOWING 7 PERCENT RISE EXPECTED IN LAST HALF OF THIS YEAR. JAPANESE ARGUED THAT INCREASE IN PRIVATE SPENDING INDUCED BY FISCAL STIMULUS WOULD SUSTAIN MOMENTUM OF RECOVERY. SECRETARIAT AND JAPANESE DID NOT COME TO MEETING OF MINDS ON THIS QUESTION; EDRC DELS REMAINED SKEPTICAL OF JAPANESE ASSESSMENT OF FISCAL POLICY IMPACT.

5. CURRENT ACCOUNT: SECRETARIAT AND EDRC DELS EMPHASIZED THAT TO BRING ABOUT SUSTAINABLE PATTERN OF INTERNATIONAL PAYMENTS, GROWTH OF DOMESTIC DEMAND IN STRONG COUNTRIES SHOULD EXCEED THAT OF GNP TO HELP INDUCE SWING TOWARD DEFICIT OF THEIR CURRENT ACCOUNT BALANCES. DELS SHARPLY CRITICAL OF FACT THAT EXPORTS LED JAPANESE GROWTH IN FIRST QUARTER OF 1977. JAPANESE CITED FIGURES TO EFFECT THAT EXTERNAL DEMAND ACCOUNTED FOR 1.5 PERCENTAGE POINTS OF THE 2.5 PERCENT RISE IN GNP IN FIRST QUARTER OF THIS YEAR (OVER FOURTH QUARTER OF 1976), A DEVELOPMENT WHICH CONSTITUTED A REVERSAL OF 1976 GROWTH PATTERN WHICH WAS LED BY DOMESTIC DEMAND. THEY EXPLAINED, HOWEVER, THAT EXPORTS IN FIRST QUARTER HAD BEEN BOOSTED, NOT ONLY BY STRONG FOREIGN DEMAND, BUT BY TEMPORARY FACTORS AS WELL, WHICH INCLUDED ANTICIPATION OF YEN APPRECIATION AND CONCENTRATION OF SALES OF BIG-TICKET ITEMS (ESPECIALLY SHIPS). MOREOVER, IMPORT ELASTICITY WAS DEPRESSED BY (A) HIGH STOCKS OF RAW MATERIALS; (B) STAGNATION OF ACTIVITY IN IMPORT-INTENSIVE SECTORS (E.G., IRON, STEEL, CHEMICALS); AND (C) SLUGGISH PERFORMANCE OF PLANT AND EQUIPMENT INVESTMENT. JAPANESE LIMITED OFFICIAL USE

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MAINTAINED THAT TEMPORARY FACTORS WHICH HAD STIMULATED EXPORTS WOULD BE REVERSED, WHILE FASTER GROWTH OF DOMESTIC DEMAND WOULD SUCK IN IMPORTS. THESE TRENDS WOULD BE INTENSIFIED BY FURTHER APPRECIATION OF YEN WITH RESULT THAT CONTRIBUTION OF EXTERNAL SECTOR GNP GROWTH WOULD DECLINE RAPIDLY IN SHORT RUN AND THAT CURRENT ACCOUNT SURPLUS WOULD BE ERASED (OR NEARLY SO) BY MARCH, 1978. THEY ARGUED THAT LEADING INDICATORS OF EXPORT/IMPORT MOVEMENTS (E.G., LETTERS OF CREDIT; EXPORT/IMPORT ORDERS OF MAJOR TRADING COMPANIES) LENT SUPPORT TO GOJ PROJECTION OF RAPID SHRINKAGE IN CURRENT ACCOUNT SURPLUS.

6. SECRETARIAT NOTED THAT ITS FORECAST OF \$6.0 BILLION JAPANESE CURRENT ACCOUNT SURPLUS FOR CY1977 ASSUMED SIGNIFICANT DECLINE IN SURPLUS DURING THE YEAR (I.E.,

FROM SURPLUS OF \$4.8 BILLION IN FIRST HALF TO \$1.2 BILLION IN SECOND HALF), AND JOINED EDRC DELS IN ATTEMPTING TO PRY OUT OF JAPANESE DEL GOJ'S CURRENT ACCOUNT FORECAST FOR CY1977. JAPANESE SUCCESSFULLY RESISTED THESE EFFORTS, AND IMPLICATION COULD BE DRAWN THAT THEY DID NOT DISAGREE WITH SECRETARIAT'S CALENDAR-YEAR FORECAST.

7. U.S. DEL STRESSED DESIRABILITY OF ACHIEVING SUSTAINABLE PAYMENTS PATTERN THROUGH AN EXPANSION OF STRONG COUNTRIES' IMPORTS AND SUGGESTED (PER REF E, PARA 16) THAT JAPANESE IMPORT REGIME WAS LESS THAN FULLY OPEN. JAPANESE ACKNOWLEDGED THAT ADMINISTRATIVE PROCEDURES OR

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OTHER FACTORS (E.G., ENVIRONMENTAL REGULATIONS) MIGHT HAVE IMPEDED IMPORTS; BUT CHARACTERIZED IMPORT REGIME AS GENERALLY OPEN. THEY ADDED THAT WHILE RESTRICTIONS ON CERTAIN AGRICULTURAL IMPORTS WERE MORE SEVERE, JAPANESE PRACTICE IN THIS RESPECT WAS NO WORSE THAN THAT OF OTHER OECD MEMBER COUNTRIES.

8. SECRETARIAT NOTED THAT APPRECIATION OF YEN WOULD CONTRIBUTE TO EFFECTING APPROPRIATE SHIFT IN PATTERN OF JAPANESE GROWTH AND COMPLAINED THAT ACCUMULATION OF OFFICIAL RESERVES INDICATED THAT GOJ WAS LEANING

AGAINST MARKET FORCES TENDENCY TO PUSH YEN UPWARD. JAPANESE RESPONDED THAT (A) INCREASE IN RESERVES WAS LARGELY DUE TO ACCUMULATION OF INTEREST ON EXISTING RESERVES; (B) VALUE OF YEN WOULD BE SET BY MARKET FORCES OPERATING THROUGH BOTH CURRENT AND CAPITAL ACCOUNT; OFFICIAL INTERVENTION WOULD BE CONFINED TO IRONING OUT "ERRATIC FLUCTUATIONS." IN REFERENCE TO POINT (B) ABOVE, JAPANESE CRITICIZED VIEW (WHICH THEY CONSIDERED IMPLICIT IN SECRETARIAT REMARKS) THAT MOVE-LIMITED OFFICIAL USE

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MENT OF EXCHANGE RATE WAS FUNDAMENTALLY DETERMINED BY TRENDS IN CURRENT ACCOUNT AND CHASTIZED SECRETARIAT FOR IGNORING INFLUENCE OF CAPITAL MOVEMENTS. IN THIS CONNECTION, JAPANESE SUGGESTED THAT THEY WERE ASSISTING ADJUSTMENT PROCESS BY THEIR INCREASED PARTICIPATION IN THE GAB AND THROUGH THEIR INTENDED CONTRIBUTION TO IMF SPECIAL CREDIT FACILITY. FINALLY, THE INDICATED THAT DIRECT INVESTMENT OUTFLOWS WERE LIKELY TO PICK UP CONCOMITANTLY WITH ECONOMIC RECOVERY IN THE OECD AREA.

9. FISCAL AND MONETARY POLICY: JAPANESE INSISTED WITH RELIGIOUS CONVICTION THAT THEY WOULD MEET THEIR STATED GROWTH TARGETS ON BASIS OF POLICIES CURRENTLY IN EFFECT OR ANNOUNCED. EDRC DELS LEANED TOWARD SECRETARIAT ASSESSMENT THAT SUCH AN OUTCOME WAS UNLIKELY. JAPANESE ALSO INDICATED, HOWEVER, THAT THEY WOULD WATCH EVOLVING ECONOMIC SITUATION CLOSELY AND WOULD TAKE "TIMELY AND APPROPRIATE" MEASURES TO ASSURE ATTAINMENT OF THEIR TARGETS. SECRETARIAT NOTED THAT STATEMENT OF JAPANESE INTENTIONS WAS NOT SUFFICIENT CAUSE FOR REVISING ITS FORECASTS WHICH WERE BASED ON STANDARD SECRETARIAT ASSUMPTION THAT NO CHANGE WILL OCCUR IN POLICIES PRESENTLY IN EFFECT OR ANNOUNCED. (NOTE: THIS ASSUMPTION UNDERLIES ALL SECRETARIAT FORECASTS. THUS, ALTHOUGH PAST EXPERIENCE POINTS TO LIKELIHOOD THAT GOJ WILL ENACT A SUPPLEMENTARY BUDGET NEXT FALL, "GROUND RULES" OF SECRETARIAT'S FORECASTING PROCEDURES, PREVENT SUCH A DEVELOPMENT FROM BEING EXPLICITLY TAKEN INTO ACCOUNT.)

10. DISCUSSION OF GOJ MONETARY POLICY WAS MINIMAL. JAPANESE DEL INDICATED THAT MONETARY POLICY WOULD REMAIN ACCOMMODATIVE IN FORESEEABLE FUTURE.

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11. CONCLUSIONS: ALTHOUGH JAPANESE AGREED THAT THEY SHOULD AIM FOR RELATIVELY HIGH GROWTH RATE AND THAT PATTERN OF GROWTH SHOULD EMPHASIZE DOMESTIC DEMAND, NO AGREEMENT WAS REACHED ON WHETHER THIS COULD BE ACHIEVED ON BASIS OF PRESENT POLICIES. THUS, JAPANESE SAW "WAIT AND SEE" POLICY STANCE AS APPROPRIATE. IN CONTRAST, SECRETARIAT AND MOST EDRC DELS WERE BEARISH ON JAPAN AND UNDERLINED NEED FOR INFUSION OF ADDITIONAL STIMULUS. HOWEVER, MAIN FOCUS OF EDRC SKEPTICISM WAS NOT WHETHER JAPANESE WOULD HIT OVERALL GNP GROWTH TARGET, BUT WHETHER PATTERN OF GROWTH WOULD BE SUPPORTIVE OF BALANCE OF PAYMENTS ADJUSTMENT PROCESS.

12. POINTS RAISED REF C, PARAS 2, 3 AND 4 COVERED PARAS 4, 5 AND 7; REF D ADDRESSED PARAS 2, 7 AND 8.
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